

Internal Revenue Service

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Third Party Communication: None

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Date: October 29, 2009

Legend:

X =

State 1 =

State 2 =

Facilities =

Dear :

This letter responds to your letter dated May 7, 2009, and subsequent correspondences, requesting a ruling under § 469 of the Internal Revenue Code. Specifically, a ruling was requested that certain interest income generated by Company be treated as derived in the ordinary course of a trade or business under § 1.469-2T(c)(3)(ii) of the Income Tax Regulations for purposes of calculating passive activity gross income.

FACTS

The information submitted states that X is an S Corporation with both active and passive shareholders for the purposes of § 469. X has been granted licenses to build Facilities in State 1 and State 2. Disregarded entities wholly owned by X entered into a

number of loan agreements in order to facilitate the payment of license fees to both states as well as Facility construction.

Under the terms of the various loan agreements, X's subsidiaries were required to immediately draw a large portion of the loan amounts and hold them in interest bearing accounts. The agreements placed strict limitations on how funds could be used. From the time the funds were dispersed to the time when the funds were needed for construction costs or license payments the funds could only be used for the payment of debt service and even then only when no other funds were available. Upon completion of the projects the remaining funds, including any interest accrued, were required to be returned to the lenders.

LAW AND ANALYSIS

Section 469 disallows the passive activity loss and the passive activity credit for the taxable year of individuals, estates, trusts, and certain types of corporations. A "passive activity" includes a trade or business activity in which the taxpayer does not materially participate. Section 469(c)(1). Taxpayers can own passive activities directly, through passthrough entities, or through certain C corporations.

In general, a taxpayer's "passive activity loss" for a taxable year equals the amount by which the taxpayer's deductions from passive activities (passive activity deductions) exceed the taxpayer's gross income from passive activities (passive activity gross income) for the taxable year. Section 469(d)(1) and § 1.469-2T(b).

Passive activity gross income and net active income do not include "portfolio income," as defined in § 469(e)(1) of the Code and § 1.469-2T(c)(3)(i) of the regulations. Portfolio income generally includes gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business.

Accordingly, § 1.469-2T(c)(3)(ii) lists the only situations in which the items of gross income described in § 1.469-2T(c)(3)(i) are considered derived in the ordinary course of a trade or business, and thus are not portfolio income for the purposes of § 469. Interest income not described in one of the specific provisions of § 1.469-2T(c)(3)(ii) may be excluded from portfolio income only if the Commissioner identifies it as income derived in the ordinary course of a trade or business under § 1.469-2T(c)(3)(ii)(G).

Example 2 in § 1.469-2T(c)(3)(iii)(B)(3) describes a situation where local law requires a partnership who operates a low income apartment building to maintain a reserve fund to pay for the maintenance and repair of the building. The example states that the interest income earned off of the reserve fund is portfolio income and thus not earned in the ordinary course of trade or business.

Senate Report No. 99-313, 99th Cong., 2d Sess (1986) states, “[t]o permit portfolio income to be offset by passive losses or credits would create the inequitable result of restricting sheltering by individuals dependent for support on wages or active business income, while permitting sheltering by those whose income is derived from an investment portfolio.” It goes on to add, “[t]he rule treating portfolio income as not from a passive activity does not apply to the extent that income, of a type generally regarded as portfolio income, is derived in the ordinary course of trade or business... the rationale for treating portfolio-type income as not from the passive activity does not apply, since deriving such income is what the business activity actually, in whole or in part, involves.”

With respect to working capital, Senate Report No. 99-313, 99th Cong., 2d Sess (1986) adds, “[n]o exception is provided for the treatment of portfolio income arising from working capital, i.e., amounts set aside for the reasonable needs of the business. Although setting aside such amounts may be necessary to the trade or business, earning portfolio income with respect to such amounts is investment-related and not a part of the trade or business itself. Under this rule, for example, interest earned on funds set aside by a limited partnership operating a shopping mall, for the purpose of expanding the mall, is treated as portfolio income and is not taken into account in determining a limited partner’s passive income or loss from the activity of operating the shopping mall.”

CONCLUSION

Based on the information submitted, we conclude that X’s income earned on the interest bearing accounts is portfolio income under section 469(e)(1)(A)(i) of the Code and section 1.469-1T(c)(3)(i)(A) of the regulations.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to X’s authorized representative.

Sincerely,

David R. Haglund

David R. Haglund
Acting Branch Chief, Branch 1
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)